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Andrew White and Chen Mee King[1]

1. INTRODUCTION

In the post-crisis environment of the past few years (since 2007–2008), risk avoidance and the management of risk have both become an increasingly prominent feature of the finance landscape. Financial institutions and regulators are today much more sensitive to the various potential areas of risk and, especially, risk contagion. At broader industry levels, this has led to new accounting standards and requirements for capital adequacy, liquidity, and leverage. Within individual financial institutions, better risk analysis and management mechanisms are being implemented, and even structural changes are occurring as many financial institutions recognise the need for risk management to move from a "back office" function often loosely parked within the credit unit, to a "middle office" function with a unified and more clearly defined enterprise-wide responsibility for not only credit risk but also operational risk, liquidity risk, market risk, legal risk, and myriad other risk exposures.

Islamic financial institutions, especially when structured and conducting business as an analogue to conventional financial institutions, face the same threshold risk/return concerns as conventional financial institutions. But as Islamic financial institutions, they also have additional unique risk concerns arising from ensuring their operations (including risk management mechanisms), investments, and products are *Shari'ah*-compliant (or even, optimally, *Shari'ah*-based). Many of these include *Shari'ah* risk (i.e., risk of non-compliance), generally, and more particularly, fiduciary risk and displaced commercial risk arising from exposure to possible rate of return disparities from higher prevailing market rates. Further, even within each conventional risk category, Islamic financial institutions face unique risks arising from the nature of *Shari'ah*-compliant operations and products. Credit risk for an Islamic bank, for example, is complicated by, among other concerns, *Shari'ah* principles that limit the remedies available to an Islamic bank in the event of (especially non-willful) default, insolvency, and other scenarios in which a counterparty fails to perform its obligations. Similarly, another significant risk area for Islamic banks, liquidity risk, is exacerbated substantially by prominent *fiqh* rulings circumscribing the use of asset securitisation by Islamic banks and, at least for the present and the immediate future, difficulties in raising funds quickly from existing money markets or LOLR (lender of last resort) facilities typically available to conventional banks unfettered by prohibition of *riba*.

2. DEFINING LEGAL RISK

Legal risk also is considerably more complicated in the context of Islamic finance than in the conventional finance space. In broad terms, this is partly because of the absence of mature legal frameworks and relatively untested legal documentation governing this still-nascent industry, and partly because of continuing uncertainty about *Shari'ah* and secular legal principles to be applied in construing and enforcing Islamic legal documents. While legal risk for Islamic financial institutions arises in the same context of credit risk, operational risk, market risk, and other risks that confront conventional financial institutions, Islamic financial institutions also face risk exposures arising from secular laws and legal-political systems that do not support (or may even be hostile to) the *Shari'ah* and *fiqh* principles[2] that govern Islamic finance; the absence of standardised legal documentation across the industry and limitations on the terms that can be included in contracts; and the absence of meaningful dispute resolution frameworks in most jurisdictions in which Islamic finance is growing.

Stated in its simplest terms, the legal risk to which a party to a transaction is exposed is the risk that either the transaction will not be enforceable against a counterparty, or that any of the transaction's terms will not be construed in accordance with the intentions of that party to the transaction. The party exposed to legal risk may be, for example, a financial institution or an investor in a *sukuk* securitisation. As with other risk exposures, legal risk does not stand alone in a financial institution's risk avoidance and mitigation framework. Most prominently, it is co-related to credit risk and market risk, for example, in that legal risk generally does not arise until a counterparty has either defaulted in payments or has lost a significant amount of money invested in a transaction. That is, once either the financial institution or the counterparty has incurred a significant loss, the next step taken by the parties is almost invariably to analyse their respective legal rights and obligations, in the context of applicable laws (including the *Shari'ah*) and regulations, as well as the contract documents, and in turn, to seek redress in an appropriate forum.

3. GREATER RISK FROM UNCERTAIN AND UNDEVELOPED LAW AND REGULATION

All financial institutions encounter legal risk exposure in the face of applicable laws and regulations. There may be uncertainty or dispute as to which law governs a cross-border transaction, for example, especially if the parties have failed to clearly state a choice of law (such as, most commonly in finance, New York law or English law). In addition, the governing law of the transaction may simply not support the legal position taken by the financial institution. Moreover, there may have been a failure of compliance with applicable regulations governing the transaction or, even more broadly, the institution.

In the context of Islamic finance, more risk exposure is introduced by application of the *Shari'ah* as an additional governing law, either explicitly stated in the contract or implied from *Shari'ah* compliance as a condition of all Islamic finance transactions. The *Shari'ah*, of course, is not a national law and its inclusion in a contract's governing law provision risks nonenforcement by a secular court, especially, either as a matter of international law such as the Rome Convention,[3] or as a matter of national public policy considerations that disfavor religious law, particularly in a commercial context.[4] The *Shari'ah* and *fiqh* principles are difficult to deduce, and despite centuries of intellectual struggle by even the most brilliant *mujtahidun* and *fuqaha'*, they remain subject to variations in interpretations and differing expert opinions across the various *madhahib* and among prominent *Shari'ah* scholars, particularly when applied to modern finance. Finally, the body of finance law that applies to Islamic finance remains relatively immature, as compared to both common law and civil code jurisprudence that has developed somewhat unimpeded over the past 500 years or more. Modern Islamic finance generally got its start in the mid-twentieth century, and virtually all Islamic finance institutions and products in the market today have been created only in the past 30–40 years.[5] Hence, there is a dearth of common law precedent and civil code jurisprudence that directly relates to Islamic finance as compared to conventional finance.[6] Moreover, most contemporary banking and finance regulations governing Islamic finance have only been promulgated since the mid-1970s to mid-1980s in Islamic-majority countries, and just in the past decade in most other countries. This lack of a clear and certain body of both Islamic jurisprudence and secular law as it applies to Islamic finance raises considerable and unique legal risk exposures for Islamic finance institutions.

4. GREATER RISK FROM POOR DOCUMENTATION

Adding to the legal risks discussed earlier, further legal risk exposure arises in the context of legal documentation. Islamic finance currently does not enjoy the comfort of relying upon standardised document templates for even the most commonly occurring transactions. Instead, most Islamic finance transactions incur added risk exposure as a consequence of frequently "reinventing the wheel" when negotiating and drafting different sets of documents across different transactions or different aspects of the same transaction. This increases the likelihood that "ordinary" errors can occur, such as all-too-frequent slip-ups in drafting and execution resulting from cut-and-pasting of inapplicable contract provisions, inappropriate signatories indicated, or failure to properly sign, witness, and date documents. In addition, substantive errors that may occur in the context of conventional finance, such as failure to adequately anticipate events of default and to correlate remedies in the documents, create risk in Islamic finance, as well.

Distinct from conventional finance, moreover, Islamic finance documentation is further complicated by contractual formalities required for *Shari'ah* compliance and the consequent legal risk of *Shari'ah* non-compliance. Significant and unique legal risk exposure is created by *fiqh* rules governing capacity of the parties and, specific to the applicable *madhhab*, rules governing timing and other formalities in sequencing, execution, and witnessing of documents in a given transaction. Drafting Islamic finance documents also requires care be taken to avoid certain terminology which otherwise is common to conventional finance,[7] as well as requiring greater clarity and specificity in key contract terms to mitigate *gharar*. Moreover, there are *fiqh* limitations that must be considered in drafting contract terms providing an Islamic financial institution with remedies in the event a counterparty fails to render a payment or delivery as required by the contract, delineating claims in insolvency proceedings, and circumscribing *Shari'ah*-compliant restructuring of finance facilities. In addition, careful attention needs to be paid when drafting contract terms that require up-front payment of fees by the counterparty in a *murabahah* transaction[8]; when drafting *band al-jazza* penalty clauses in *istisna'a* contracts; drafting rebate clauses in the event of early settlement by the counterparty[9]; and in drafting arbitration or other dispute resolution clauses in the contract.

Indeed, the very structuring of Islamic finance transactions is complicated by anticipation of legal risk exposure and attempts to incorporate corresponding risk mitigation techniques in the documentation. These include multiple-step or even parallel contracts in *murabahah* structures, as well as agency agreements appointing the finance institution or counterparty, respectively, as an agent for the other party in basic *murabahah* structures, as well as *tawarruq* and other commodity *murabahah* structures.[10] And in anticipation of a *Shari'ah*–non-compliance defense later by a counterparty in an attempt to avoid liability or enforcement of contract terms, Islamic financial institutions may seek to mitigate legal risk exposure by including in the transaction documentation a confirmation by the counterparty that it has independently made its own assessment that the transaction is fully *Shari'ah* compliant.[11]

5. GREATER RISK FROM UNPREDICTABLE DISPUTE RESOLUTION PROCESSES

The above-described legal risk exposures for Islamic financial institutions are often characterised as falling within the following categories: (a) "product risk," arising when a financial institution introduces a new product or changes an existing product; (b) "counterparty risk," such as when a counterparty lacks requisite capacity or authority to enter into a particular transaction; and, most commonly, (c) "transaction risk," arising from negotiations and drafting of documents that either fail to comply with legal/regulatory requirements, fail to accurately reflect the parties' intentions, contain unenforceable terms and conditions (including those that are *Shari'ah*–non-compliant), or simply contain drafting errors.

Islamic finance institutions also face a further significant category of legal risk, however, often characterised as "process risk." This risk category arises in the context of litigation or other legal processes to resolve legal disputes. Internally, it includes risk exposure that arises from insufficient record-keeping and other information processes within a financial institution. Externally, it arises from the legal processes that are utilised in resolving disputes, such as litigation, arbitration, and other formal and informal dispute resolution frameworks.

In the case of Islamic finance, dispute resolution especially presents unique risk concerns, as well as unique opportunities. All Islamic finance market participants, whether financial institutions or counterparties transacting with them, seek stability and reliability and avoid volatility and risk.

Essential to this is a reliable, predictable, just, fair system of dispute resolution, and preferably one that has clear authority and legitimacy in the context of Islam. Some Islamic scholars have gone so far as to suggest that any dispute resolution based upon reference to secular fora or secular law is in violation of the *Shari'ah*. Furthermore, a significant risk concern is that a secular forum will not enforce all the provisions of Islamic finance contracts, particularly provisions making reference to the *Shari'ah*, or that they will not render judicial determinations consistent with the letter, and especially the more nuanced spirit, of the *Shari'ah*.

Dispute resolution in the context of Islamic finance is distinguished from conventional finance by an overlay of *Shari'ah* and *fiqh* principles, requiring the intermediary[12] in the dispute to have a thorough knowledge of the *Shari'ah* and doctrines of the various *madhahib* governing a particular Islamic finance transaction. When confronted with complex Islamic finance products and structures, therefore, it is not sufficient that the courts simply understand basic concepts of conventional finance, their ostensibly analogous counterparts in Islamic finance, and the secular commercial law of the given jurisdiction. Indeed, even the fundamental principles of Islamic law may be quite elusive to conventional legal scholars and jurists lacking in-depth education and experience in the subject. Contemporary Islamic finance transactions significantly transcend a simple set of clearly defined rules based on what is *halal* and what is *haram*, and even in-house *Shari'ah* advisors charged with determining the permissibility of certain financial products and structures often find themselves in a quandary. The difficulty in fully understanding Islamic law and finance, and applying or incorporating the concepts, principles and rules correctly into transactions and documentation entered into by financial institutions, significantly increases the legal risk exposure for an Islamic finance institution.

In addition, parties to an Islamic finance transaction may also encounter difficulty in persuading a court to enforce fully the terms of the transaction, or to interpret them in full accordance with the *Shari'ah*, especially if there is conflict with the relevant and controlling law of the state. Including a clear choice of the *Shari'ah* as governing law in the transaction documents may still be wise from a practical perspective as well as in meeting the religious interests of the parties. Particularly in a secular (non-*Shari'ah*-incorporated) jurisdiction, however, secular courts may refuse to enforce a *Shari'ah* choice of law, on grounds of public policy or established private international law (conflict of laws) principles. As discussed above, private international law rules generally permit only one legal system to govern a contract, and then only the law of a country and not non-state or religious law. In the case of *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC*,[13] for example, an English court refused to enforce the contract's governing law provision asserting that the contract be "[s]ubject to the Glorious Sharia'a," instead deferring to the laws of England. Significantly, the *Beximco* court also noted "considerable controversy and difficulty" in translating traditional *fiqh* into propositions of modern law, as well as the "existence of a variety of schools of thought with which the court may have to concern itself" before a case applying the *Shari'ah* can be decided. As underscored by *Beximco*, in fact, before the parties are even able to address the merits of their respective positions in a legal dispute, the parties are also faced with the difficult task of assisting the court in understanding the complexities of the *Shari'ah*, applicable *fiqh*, and industry practices and standards applicable in a given Islamic finance transaction.

An important mitigant to the legal risk inherent in Islamic finance dispute resolution is the rapidly growing use of arbitration and other forms of alternative dispute resolution (ADR) in Islamic finance.[14] Bypassing especially the secular courts in favor of ADR provides desperately needed subject matter expertise in Islamic finance dispute resolution.[15] In addition, an ADR intermediary is generally not constrained by private international law principles, such as those discussed above in the context of *Beximco*, limiting the parties' ability to choose the *Shari'ah* as governing law in their transaction. Instead, an ADR intermediary should in most jurisdictions be free to decide disputes in accordance with any principles as the parties agree, including legal principles other than national law, such as the *Shari'ah*.[16] Moreover, particularly if there is a concern about the recognition of foreign judgments across borders, especially judgments based upon *Shari'ah* principles, arbitration is likely to afford the parties broad enforceability under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, to which 146 countries are currently signatories.[17]

In choosing an ADR forum and intermediary for Islamic finance disputes, a cautionary note should be expressed with respect to the ADR provision drafted by the parties, in order to ameliorate rather than exacerbate process risk exposure. It is common practice for most lawyers to simply include in Islamic finance documents a standard ADR clause, mirroring the clauses used in conventional transactions. These clauses usually provide for arbitration and/or mediation in accordance with applicable statutory law, if any, and further incorporate by reference a particular ADR institution's rules or other procedural framework. As the Islamic finance industry continues to grow and mature, and as rapidly increasing numbers of defaults have been arising in the context of Islamic finance, dispute resolution clauses and agreements need to be more of a forethought than an afterthought. Greater innovation in drafting ADR clauses is needed, carefully setting forth the agreed upon qualifications and expertise of the ADR intermediary, for example, as well as the particular *madhhab* and specific principles of *fiqh al-mu'amalat*, and any industry standards promulgated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), and other international standard setting bodies.[18]

6. CONCLUDING REMARKS

It is ironic that the very foundation that makes Islamic finance a potentially thriving industry—the *Shari'ah* and its role in suggesting antidotes to many of the underlying ills of conventional finance—is also the unique factor that increases legal risk exposure in modern Islamic finance as compared with conventional finance. While the industry demands that products and operations of Islamic financial institutions be fully *Shari'ah*-compliant, most jurisdictions' surrounding legal frameworks of laws, regulations, and courts generally do not support application of the *Shari'ah* in Islamic finance transaction and, in some cases, may be hostile toward the application of *Shari'ah*. Indeed, Islamic finance finds itself in a most peculiar and unique position of relying upon a body of finance law that is rigorously applied from inception to the conclusion of a given transaction in terms of concepts, principles, and rules (always under the watchful eyes of a *Shari'ah* Supervisory Board), yet it is seldom specified or enforced as the governing law for the construction, interpretation and dispute resolution regarding the given transaction and documentation.

Indeed, while the *Shari'ah* is the one necessary component in all aspects of Islamic finance, it becomes an unwelcome guest after the product has been structured and, in fact, becomes a potential liability from the perspective of legal risk exposure. It appears that much more legal risk exposure is incurred in an Islamic finance transaction, as the transaction and documentation surrounding it are carefully structured to comply with a particular body of law (the *Shari'ah*), but with the further reality that yet a different or additional (secular) law will govern the transaction instead. In short, instead of effectively mitigating the legal risks of the financial institution in relation to the transaction, the financial institution's legal risks have, on the contrary, increased.

It is suggested in this chapter that the solution to this ironic disconnect between the intentions of the Islamic finance industry to find a path which is less risky for all participants than conventional finance, and the reality of *Shari'ah* compliance actually causing more problems than it avoids, lies simply with much greater education and awareness of the basic principles of Islamic finance on the part of all the industry players. It is the lack of understanding and experience that results in faulty structuring of Islamic finance transactions, the usage of inappropriate terminology, charging of rates or upfront fees that are not *Shari'ah*-compliant, or documentation that is actually inconsistent with the very Islamic concepts upon which the transaction is based.[19] While it may involve considerable time, effort and costs, which financial institutions, regulators and other industry players generally may not be willing yet to expend at this still-early stage of development, it is imperative that much more thought and effort be invested in knowledge development as the first step towards having the meaningful legal risk management process that is proving to be essential for Islamic finance.[20] With deeper knowledge and greater understanding of Islamic finance and the *Shari'ah* and *fiqh* principles upon which it is based, comes better and more innovative structuring, clearer and tighter documentation, more reliable dispute resolution, and a stronger framework of enabling laws and regulations needed for better legal risk mitigation and avoidance.

NOTES

1. Professor Andrew White is the Director of the International Islamic Law & Finance Centre and Associate Professor of Law, Singapore Management University. Mrs. Chen Mee King is Senior Vice President, Head of Legal and Corporate Secretariat, Legal and *Shari'ah* Group, The Islamic Bank of Asia Limited (Singapore & Bahrain); Mrs. Chen is also an Adjunct Associate Professor of Law, Singapore Management University. The views expressed in this chapter do not necessarily express the views of either the SMU or The Islamic Bank of Asia Limited.
2. While much of the contemporary authoritative literature (e.g., AAOIFI *Shari'ah* standards and IFSB standards) uses the terminology, "*Shari'ah* rules and principles" as a comprehensive concept that refers to both the *Shari'ah* and *fiqh*, subtle distinction between the two must be kept in mind. *Shari'ah* is a divinely ordained path; *fiqh* is the product of rational human endeavor (hence the various *madhahib* of slightly differentiated *fiqh*), practical rules derived through a combination of interpretation and *ijtihad* from detailed evidence in the sources of the *Shari'ah* (a process generally regulated by *usul al-fiqh*). And while the *Shari'ah* broadly governs the Islamic finance industry, it is *fiqh* that is criticised and debated in determining points of agreement, as well as disagreement across *madhahib*, as to the validity of structures and contract terms.
3. In the EU, for example, the Convention on the Law Applicable to Contractual Obligations 1980, known as the Rome Convention, mandates that contracts be governed by only the legal system of a country. This principle was emphasised in the context of Islamic finance in the English case of *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004), in the Supreme Court of Judicature, Court of Appeal (Civil Division), on appeal from the High Court of Justice Queen's Bench Division (Morison J).

4. Indeed, a "pretty good way to generate an outcry, as the Archbishop of Canterbury learned in Britain recently, is to say that a Western legal system should make room for Shariah, or Islamic law." Adam Liptak, "When God and the Law Don't Square" *The New York Times* (17 February 2008), www.nytimes.com/2008/02/17/weekinreview/17liptak.html?pagewanted=print.
5. It should be noted that modern Islamic finance products generally are based upon nominate contract schemes and partnership principles that date back to (and even pre-date in some cases) the revelation of Islam, although their development as analogues to conventional finance facilities began in the 1970s and 1980s.
6. A recent project undertaken by students at the Singapore Management University, for example, identified fewer than two dozen reported Islamic finance cases across all common law jurisdictions, as at March 2012.
7. It is surprising that conventional finance terminology such as "repayment," "loan," "interest," "guaranteed rate of return," and indiscriminate use of "late payment penalty" clauses, may still be found in some Term Sheets and other Islamic finance documentation.
8. "Upfront Fees" and "Commitment Fees," which are usually paid upfront or for the commitment to provide a facility, would generally not be acceptable. Fees paid should be in respect of services performed or to be performed in relation to the transaction.
9. Rebate may be requested or may be given at the discretion of the recipient of the early settlement or payment amount, without any rate or formulae being specified or referenced.
10. Although such provisions are not sure or conclusive ways to handle the risks, it is not unusual to find included in the transaction documentation various provisions imposing upon the counterparty, as agent for the financial institution, an obligation to ensure that the assets purchased by it are as required by specifications; this may be helpful later to the financial institution if necessary to claim a defense or even a counterclaim against the counterparty, in the event the counterparty (as purchaser) brings a claim against the financial institution for breach of warranty.
11. This may help avoid precisely the problems encountered in *The Investment Dar Company KSCC v. Blom Developments Bank SAL* [2009] EWHC 3545 (Ch).
12. Typically, this is a secular trial judge, or—if an alternative form of dispute resolution is agreed upon by the parties—a designated arbitrator or a mediator, often acting administratively within the framework of a formal dispute-resolution institution.
13. See note 3, *supra*, *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19 (28 January 2004), in the Supreme Court of Judicature, Court of Appeal (Civil Division), on appeal from the High Court of Justice Queen's Bench Division (Morison J).
14. In the context of Islamic finance dispute resolution, it has been suggested that the conventional term, ADR, be replaced with a more appropriate term, IDR, encompassing a form of Islamic dispute resolution that incorporates both

substantive and procedural approaches to dispute resolution inherent in Islamic legal tradition. This innovative concept is discussed at length in Andrew White, "Dispute Resolution and Specialized ADR for Islamic Finance," Chapter 12, *Islamic Finance: Law and Practice*, edited by Craig R. Nethercott and David M. Eisenberg (Oxford, UK: Oxford University Press, 2012).

15. At the same time, ADR for Islamic finance can also accommodate Islamic legal values and traditions, resurrecting the traditional Islamic concept of dispute settlement (*sulh*), and subsuming notions of non-binding mediation (*wasata*) and binding arbitration (*tahkim*) into a single ADR process. (Source: see note 14).
16. Not long after the decision in *Beximco*, the English High Court of Justice (Chancery Division) held that the *Shari'ah* may be applied to the subject matter and resolution of a dispute in arbitration, where the parties have so chosen in the contract itself. In *Musawi v RE International (UK) Ltd & Ors*, [2007] EWHC 2981 (Ch) (14 December 2007), the court held that although only English law could govern the interpretation of the agreement itself, resolution of the actual dispute between the parties was to be in accordance with the *Shari'ah*.
17. See www.newyorkconvention.org/new-york-convention-countries as of 26 February 2012.
18. This is discussed in greater detail, and a suggested IDR clause is provided, in Andrew White, "Dispute Resolution and Specialized ADR for Islamic Finance," *supra* note 14.
19. A good example is the use of clauses that effectively promise fixed returns in a transaction based on *wakala*, such as apparently occurred in the *TID v Blom* transaction, *supra* note 11.
20. Fortunately, the shortage of experts with education, training, and experience in the *Sharï'ah*, applicable secular commercial law, and Islamic finance is currently being addressed in the interest of increasing overall "human capital" available to the Islamic finance industry. The absence of facilitative legal and institutional frameworks, however, remains largely unaddressed, even in countries with significant Muslim populations.